

**STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
300 Capitol Mall, 17th Floor
Sacramento, California 95814**

REVISED FINAL STATEMENT OF REASONS

FREQUENCY AND SEVERITY BANDS MANUAL

OAL Notice File Number: Z-2008-1219-02
CDI File Number: REG-2008-00028
October 23, 2009

PROCEDURAL HISTORY

On January 2, 2009, the Department of Insurance gave notice of the proposed adoption of amendments to California Code of Regulations (“CCR”) Title 10, Chapter 5, Subchapter 4.7, Article 3, Section 2632.9. Notice of the proposed regulatory action was published in the California Regulatory Notice Register on January 2, 2009.

The notice stated that the proposed changes would implement the provisions of Insurance Code section 1861.02 by ensuring that private passenger automobile insurers will be able to implement the 2006 amendments to the automobile rating factor regulations through the use of updated, credible frequency and severity claims and exposure data.

After considering public comments on the proposed regulation, the Department of Insurance made no changes to the proposed regulation.

UPDATE OF INITIAL STATEMENT OF REASONS

The Initial Statement of Reasons included in this rulemaking file continues to fully and accurately reflect the views of the Department of Insurance. Therefore, it is incorporated herein by this reference.

UPDATE OF MATERIAL RELIED UPON

No material other than that presented in the initial statement of reasons has been relied upon by the Department of Insurance.

MANDATE ON LOCAL AGENCIES OR SCHOOL DISTRICTS

The Department has made a determination that adoption, amendment or repeal of the regulation does not impose a mandate on local agencies or school districts. The regulation has nothing to do with local agencies or school districts; it neither requires nor prohibits action on their part.

INCORPORATION BY REFERENCE

Title 1, Section 20 of the California Code of Regulations states the five conditions which must be met to allow an agency to incorporate by reference another document. First, it would be cumbersome and impractical to publish an approximately 200-page Excel spreadsheet of private passenger automobile claims frequency and severity loss statistics in the California Code of Regulations. Second, the Frequency and Severity Bands Manual was available upon request directly from the Department of Insurance and was available from the Department of Insurance public website. Third, the Frequency and Severity Bands Manual is clearly identified in the Notice of Proposed Action. Fourth, the regulation text states the Frequency and Severity Bands Manual is incorporated by reference and identifies the Bands Manual by title and date of publication or revision. Fifth, the regulation text specifies the entire Frequency and Severity Bands Manual is being incorporated by reference.

REASONABLE ALTERNATIVES TO THE REGULATIONS; IMPACT ON SMALL BUSINESS

The Commissioner has identified no reasonable alternatives to the presently proposed regulations, nor have any such alternatives otherwise been identified and brought to the attention of the Department of Insurance, that would be more effective in carrying out the purpose for which the amended regulations are proposed, or which would lessen any impact on small business, than the proposed regulation.

ALTERNATIVES:

The Commissioner must determine that no reasonable alternative considered by the Commissioner or that has otherwise been identified and brought to the attention of the Commissioner would be more effective in carrying out the purposes for which the regulations are proposed or would be as effective as and less burdensome to affected private persons than the proposed regulations. The Commissioner invited public comment on alternatives to the regulations with the January 2, 2009, Notice of Proposed Action and Notice of Public Hearing. No alternatives to the regulation (including alternatives to lessen any adverse economic impact on small businesses), other than those reflected in the comments during the rulemaking proceeding, were presented to or considered by the Commissioner.

After a review of the alternatives presented, the Commissioner has determined that no alternative would be more effective in carrying out the purpose for which the regulations are proposed, or would be as effective and less burdensome to affected private persons or small businesses than the proposed regulations [Government Code section 11346.9(a)(4)].

SUMMARY OF AND RESPONSE TO OBJECTIONS OR RECOMMENDATIONS

A verbatim recital of each written and oral comment, objection, and/or recommendation received during the public comment period and the response to each is attached hereto.

The following descriptive codes are used to describe the written comments:

“L” denotes “Letter.” Each piece of correspondence bears a unique “L” number.

“C” denotes “comment.” Each category of comment topic within each letter is identified.

The numeric sequence for comments starts a “1” for each letter.

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COMMENTS	SECTION	VERBATIM COMMENT (All mistakes in text appear in original)	CDI RESPONSE
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Topic 1: Controlling for the Effects of Other Rating Variables

James E. Masek, Insurance Services Office, Inc. (ISO) Comment letter February 20, 2009 (L1, C1)	2632.9	<p>When analyzing the impact of location upon an insured's propensity for loss, it is desirable to control for other factors that vary by area which may distort the geographic analysis. A simple example would be to assume that there are only 2 ZIP Codes in California, say A and B, with the only difference between the two ZIP Codes being that ZIP Code A contains only drivers who were licensed less than one year, while ZIP Code B contains only drivers that have been licensed for more than 20 years. Without controlling for the differences in driver years licensed between the two ZIPs, ZIP Code A's data would indicate higher aggregate losses than ZIP Code B's. While this example is extreme in nature, differences in driver and vehicle characteristics do vary by area across the state.</p> <p>This issue is addressed for the <i>band rating process</i> in Section 2632.7 of Title 10 of the California Code of Regulations, which requires that "The determination of the initial relativities to associate with a rating factor shall be established by performing a sequential analysis. The sequential analysis shall remove the variation in loss costs already explained by prior factors." In the example above, the sequential analysis adjusts the data for ZIP Code A to reflect the higher proportion of inexperienced drivers before rating the different ZIP Codes. The sequential analysis controls for the effects of other rating factors in the <i>band rating process</i>, but there are currently no</p>	<p>There are two reasons for not changing Section 2632.9 in response to this comment. First, allowing adjustments to the Bands Manual data to control for the effect of other rating variables on losses would significantly increase the complexity of regulatory review of class plans submitted by insurers. As an example, the Department does not have and does not routinely collect, even at an industry level, driver and vehicle characteristic rating data. For the Department and insurers, such data would be costly to collect and would be the minimum data necessary to verify insurer zip code data on driver and vehicle characteristics used to accomplish adjustments.</p> <p>Second, the example posed by the comment is unrealistic in two important ways. Differences in Years Driving Experience by zip code will not be nearly as extreme as the example provided, and adjustments (depending on the adjustment methodology) may be negligible. Given that Years Licensed is determined by age, this comment suggests there is systematic variation in the age distribution of insureds (and statistically significant variation of losses as well) by zip code. Extreme examples would be zip codes composed mostly of retirement communities in California or college campuses. Of</p>
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		<p>controls for the effects of other rating factors <i>in the band selection process</i>.</p> <p>Section 2632.9(d) of Title 10 of the California Code of Regulations states that:</p> <p style="padding-left: 20px;">In the event that an insurer lacks credible data at the census tract level, they shall use zip code data. If the insurer's own zip code data is not fully credible, it shall use the claims frequency and severity for the zip code that is published in the manual described in Section 2632.9(e) either:</p> <p style="padding-left: 20px;">(1) directly as it is published, or</p> <p style="padding-left: 20px;">(2) to credibility adjust their own data. In the case where the manual indicates that the rate published in the manual has been credibility adjusted, an insurer may:</p> <p style="padding-left: 40px;">(A) use the credibility adjusted rate in the manual as the complement of credibility, or</p> <p style="padding-left: 40px;">(B) combine the unadjusted data published in the manual with its own unadjusted data. If this combined data is still not credible, then an insurer may elect to use as the complement of credibility either:</p> <p style="padding-left: 60px;">1. the rate published in the manual for the CAARP territory that the zip code is a member of, or</p> <p style="padding-left: 60px;">2. the rate based on their own data or data from the manual from another grouping of contiguous whole zip codes, selected by the insurer, that is fully credible and contains said zip code.</p> <p>Therefore, companies can either use the frequency and severity bands promulgated by the California Department of Insurance in the California Bands manual, or develop their own frequency and severity bands</p>	<p>the more than 1800 zip codes used for auto rating, such zip codes comprise fewer than 3 percent of California's zip codes.</p> <p>Equally important, the example is unrealistic because other driver characteristics, for example, Safety Record or commute use and commute mileage, could also affect losses. Whatever the adjustment methodology, it would need to simultaneously account for any rating factor that could systematically affect the zip code loss data. While the statistical tools for such analysis are widely available and used routinely, this practice would add another layer of complexity to the Department's regulatory review of insurer submitted class plans.</p>

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		<p>using a combination of their own data and data from the California Bands manual. However, in both cases, there is no control for the effects of other rating factors.</p> <p>The California Bands manual currently aggregates data reported to the California Department of Insurance by ZIP Code, uses that data to calculate credibility-weighted frequencies and severities (by weighing individual ZIP Code experience with statewide averages for ZIP Codes that are not fully actuarially credible), and creates bands of roughly equal size based upon these frequencies and severities. There is no adjustment for differences in distributions of rating factors, deductibles, or vehicle age & symbol. As illustrated earlier, this could lead to inaccurate ZIP Codes classification. Ideally, the California Department of Insurance could provide, in addition to the data, the average rating factors underlying the data, so that the <i>band selection process</i> would control for other rating factors. However, this may be difficult, since there is no uniform consensus on what the rating factors, or the relativities for those rating factors, should be.</p> <p>As an alternative, companies choosing to develop their own bands could be allowed to adjust both their data and the data published in the manual, <i>solely</i> for the purpose of controlling for other rating factors. This is consistent with the sequential analysis done for the <i>band rating process</i>, and would result in more accurate band definitions.</p> <p>ISO recommends that the California DOI consider the following amendment (shown in bold face italics) to the existing regulation:</p> <p>In the event that an insurer lacks credible data at the census</p>	

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		<p>tract level, they shall use zip code data. If the insurer's own zip code data is not fully credible, it shall use the claims frequency and severity for the zip code that is published in the manual described in Section 2632.9(e) either:</p> <p>(1) directly as it is published, or</p> <p>(2) to credibility adjust their own data. In the case where the manual indicates that the rate published in the manual has been credibility adjusted, an insurer may:</p> <p>(A) use the credibility adjusted rate in the manual as the complement of credibility, or</p> <p>(8) combine the unadjusted data published in the manual with its own unadjusted data. If this combined data is still not credible, then an insurer may elect to use as the compliment of credibility either:</p> <p>1. the rate published in the manual for the CAARP territory that the zip code is a member of, or</p> <p>2. the rate based on their own data or data from the manual from another grouping of contiguous whole zip codes, selected by the insurer, that is fully credible and contains said zip code.</p> <p><i>In either case, an insurer may adjust the data to remove any variation in loss costs already explained by other rating factors.</i></p>	
<p>Topic 2: Comprehensive Coverage Data</p>			
James E. Masek, Insurance Services Office, Inc. (ISO)	2632.9	<p><i>Comprehensive Coverage Data</i></p> <p>Comprehensive coverage (otherwise known as Other Than Collision or OTC) insures a driver's vehicle against several different perils, including, but not limited to fire, theft, and wind & water damages. A common actuarial adjustment to data for Comprehensive is to adjust wind & water losses for large storms or flooding. These storms can</p>	<p>There are two reasons for not changing Section 2632.9 in response to this comment. First, our examination of the 2008 Bands Manual data did not reveal empirical evidence that aggregate losses are overstated due to catastrophe losses. The 2008 Bands Manual includes data for Comprehensive coverage in 2003 when California experienced its most devastating wildfire</p>

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<p>Comment letter</p> <p>February 20, 2009</p> <p>(L1, C2)</p>		<p>cause significant losses in localized areas. As a result, some ZIP Codes can experience extreme losses in one year, and relatively small losses in most other years.</p> <p>The California Band Manual displays losses aggregated over all years and causes of loss. As a result, it is not possible to determine if a ZIP Code incurred losses due to an extreme event that is unlikely to occur again. Therefore, the aggregate losses for some ZIP Codes may be overstated in the California Band Manual due to the inclusion of these "catastrophe" losses. If data was available either by year, by cause of loss, or both, excess storm losses in the California Band Manual data can be identified and capped, using reasonable assumptions.</p> <p>However, even if this data was available in the California Band Manual, the regulation implies that adjustments for catastrophe losses for Comprehensive coverage would not be allowed since Section 2632.9(2)(B)2 requires the use of unadjusted data.</p> <p>ISO recommends that the California DOI consider providing detailed data in the California Band Manual by year and by cause of loss and that the following amendment (shown in bold face italics) to the existing regulation be considered:</p> <p>In the event that an insurer lacks credible data at the census tract level, they shall use zip code data. If the insurer's own zip code data is not fully credible, it shall use the claims frequency and severity for the zip code that is published in the manual described in Section 2632.9(e) either:</p> <p>(1) directly as it is published, or</p> <p>(2) to credibility adjust their own data. In the case where the manual indicates that the rate published in the manual has been credibility adjusted, an insurer may:</p> <p>(A) use the credibility adjusted rate in the manual as the complement of credibility, or</p>	<p>losses, including the Cedar and Old fires. Although zip codes with extensive damage to residential structures could have higher claim frequency and higher claim severity (many fire damaged autos are a complete loss), we found little evidence to confirm that hypothesis. For zip codes affected by the Cedar and Old fires, claim frequency and the absolute number of claims was lower in 2003 compared to the prior years 2000-2002. Claim severity was also lower in 2003 in comparison to 2000-2002. Second, the data on which the 2008 Bands Manual is based is collected by the Department from individual auto insurers in California under Section 11628. The addition of new data by year and cause of loss would increase the cost of data provision for all California auto insurers. Given that we could not find evidence of wildfire losses in the 2003 data, imposing such costs on insurers appears unjustified.</p>

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		<p>(B) combine the unadjusted data published in the manual with its own unadjusted data. If this combined data is still not credible, then an insurer may elect to use as the compliment of credibility either:</p> <ol style="list-style-type: none"> 1. the rate published in the manual for the CAARP territory that the zip code is a member of, or 2. the rate based on their own data or data from the manual from another grouping of contiguous whole zip codes, selected by the insurer, that is fully credible and contains said zip code. <p><i>In either case, an insurer may adjust the data to:</i></p> <ul style="list-style-type: none"> • <i>remove any variation in loss costs already explained by other rating factors;</i> • <i>account for catastrophic Comprehensive claims.</i> 	